SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

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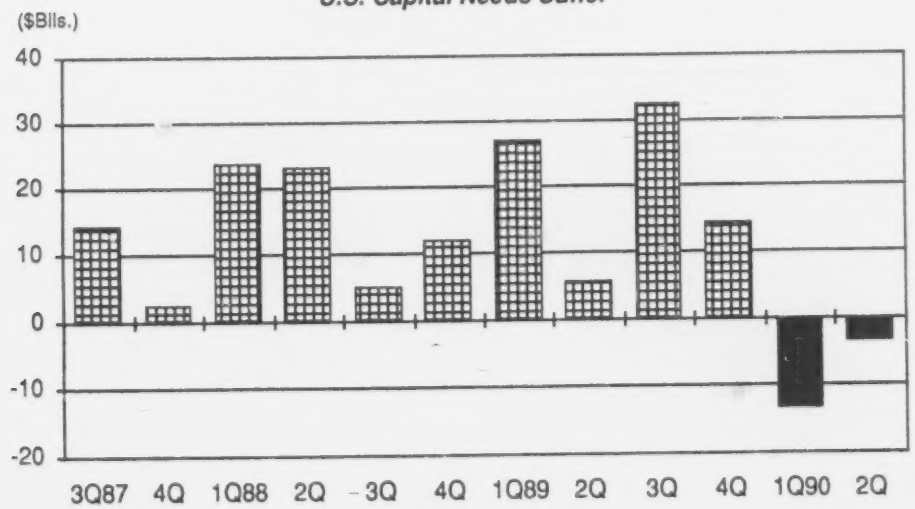
From Locomotive To Caboose?

With both the U.S. dollar and economy weakening, the U.S. capital markets experienced net portfolio outflows in 2Q90 for the second consecutive quarter. That is, $3.8 billion more in capital left the U.S. than came in, bringing the year-to-date outflow to $17.7 billion. Specifically, in 2Q90, U.S. investors made record quarterly net purchases of $11.5 billion of foreign securities, while foreign investors made net purchases of U.S. securities totalling $7.7 billion. Importantly, the major suppliers of U.S. capital in the 1980s, the Japanese, have accounted for more than half of all net portfolio outflows. In addition, and as we will discuss later, foreign direct investment has also been sharply curtailed. Given concern over a U.S. recession, combined with inflation and the likely continued weakening of the buck, foreign inflows cannot soon be expected to reach the levels achieved during the 1980s.

Net Portfolio Investment:
U.S. Capital Needs Suffer



The net portfolio outflows over the past two quarters have no doubt contributed to an already weak greenback, as well as the lackluster performance of U.S. securities markets. To put the U.S. capital drain in perspective, the reader need only look at the U.S. equity markets. Foreign and U.S. investors both have found non-U.S. equities of

growing interest. The combination of foreign investor net sales of U.S. stocks ($6.8 billion) and U.S. net purchases of foreign stocks ($6.2 billion) has reduced the potential demand for U.S. equities by some $13 billion during 1H90. In stark contrast, foreign investors were net buyers in 1987 of $16.3 billion while U.S. investors made net sales of $1.5 billion. This resulted in increased potential demand of $17.8 billion for the entire year. Given that the pricing of stocks is determined at the margin, we believe this double-barrelled impact has had major negative implications for U.S. equity markets.

Foreign Interest In U.S. Equities: "Neither A Borrower, Nor A Lender Be"

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES BY FOREIGN INVESTORS
($Mils.)

	FIRST QUARTER 1990		*SECOND QUARTER 1990*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 2Q90-1Q90*
EUROPE	**$44,855**	**($1,317)**	**$42,694**	**($2,318)**	**(4.8%)**
BELGIUM-LUXEMBOURG	3,823	209	3,338	(570)	(12.7%)
FRANCE	2,939	(305)	3,582	(242)	21.9%
GERMANY	3,105	149	3,360	(118)	8.2%
NETHERLANDS	1,588	(18)	1,419	(129)	(10.6%)
SWITZERLAND	7,634	(922)	7,381	(767)	(3.3%)
UNITED KINGDOM	22,793	(811)	23,682	(426)	3.9%
CANADA	**9,077**	**(253)**	**9,178**	**(284)**	**1.1%**
LATIN AMERICA & CARIBBEAN	**13,019**	**(497)**	**13,051**	**49**	**0.2%**
BERMUDA	3,018	(24)	2,662	(92)	(11.8%)
NETHERLANDS ANTILLES	4,275	(395)	4,213	255	(1.5%)
ASIA	**21,612**	**(1,080)**	**22,987**	**(977)**	**6.4%**
HONG KONG	2,590	4	2,286	(128)	(11.7%)
JAPAN	13,868	(702)	16,057	(329)	15.8%
OIL EXPORTING COUNTRIES	4,000	(358)	3,511	(551)	(12.2%)
TOTAL ALL COUNTRIES*	**$90,579**	**($3,299)**	**$93,213**	**($3,529)**	**2.9%**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

Foreign investors, whose already diminished appetite for U.S. equities was further weakened by worries over an increasingly fragile U.S. economy, once again made net sales of U.S. equities. Net sales of $3.5 billion in 2Q90 pushed half-year divestment to $6.8 billion. In comparison, previous record net sales were "only" $2.9 billion (1984). Indeed, given the events of 3Q90, 1990 may end with a reduction in foreign holdings of U.S. equities for the first time since 1984, and in significantly larger amounts.

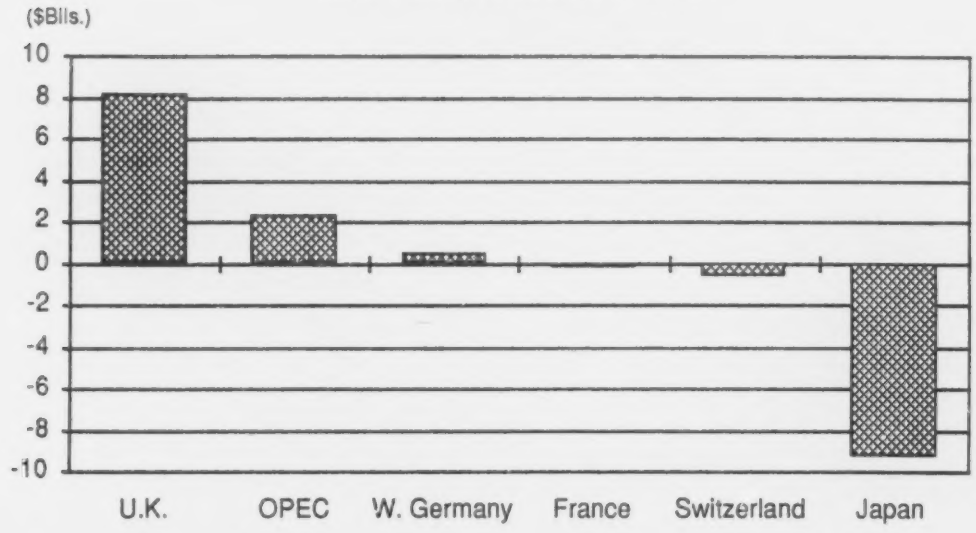
Gross activity in 2Q90 increased marginally to $93.2 billion, bringing the year-to-date total to $183.8 billion.

Foreign investors from all major geographical areas sold U.S. equities. While global investors have recently shunned U.S. equities to take advantage of non-U.S. investment opportunities, particularly in Europe, the precarious footing of the U.S. economy and dollar seems to be another substantial impediment to foreign interest in U.S. equities. European investors highlighted the "new" approach toward U.S. equities making net sales of $2.3 billion in 2Q90 compared to net purchases of $548 million in 2Q89. Indeed, every major European area made net sales of U.S. equities.

Japanese investors made net sales of $300 million, and over $1 billion for the 1H90. The investment posture of these investors has been increasingly determined by domestic economic troubles. Indeed, with Japanese interest rates increasing, equity prices declining 27%, and a rise in the Yen relative to the dollar, U.S. investments have become unattractive to these investors. And, as we've noted in the past, the rapid accumulation of U.S. securities in the 1980s may have also left these investors comfortable enough with the ratio of foreign securities in their portfolios that they no longer need look outside their home markets as they did in the past decade.

On a broader note, the Japanese investor, a prime supplier of U.S. capital in the 1980s, has taken a mirror-image posture in the 1990s. As the graph shows, in the 1H90, Japanese investors removed almost $10 billion in capital from the U.S. Not only did this have a negative impact on U.S. securities prices but we suspect that Japanese sales of U.S. securities, combined with a reduction in Japanese foreign exchange reserves from $91 billion at the beginning of 1Q90 to $66 billion at the end of 2Q90, led to a weakening in the dollar relative to the Yen.

Net Activity In U.S. Securities By Major Foreign Investors In 1H90



The aggregate data, though, masks the strong negative posture that these investors have taken in the U.S. Treasury market. Net sales of over $8.3 billion for 1H90 exceed that made by any other country and are in sharp contrast to the Japanese posture in the 1980s, when net purchasers were made in every year. Indeed, except for paltry net acquisitions of U.S. corporate bonds totalling $60 million, the Japanese have been net sellers of all other U.S. securities.

Foreign Investment In U.S. Treasuries:
A Departure From The U.S. Markets

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. TREASURY NOTES AND BONDS BY FOREIGN INVESTORS
($Mils.)

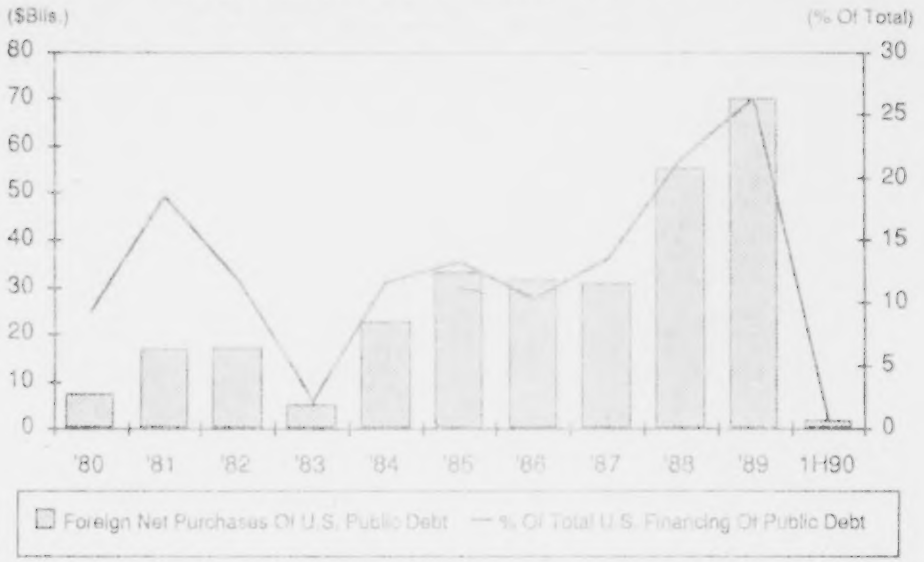
	FIRST QUARTER 1990		SECOND QUARTER 1990		% CHANGE
	GROSS ACTIVITY	NET PURCHASES	GROSS ACTIVITY	NET PURCHASES	IN GA 2Q90-1Q90
EUROPE	$364,112	$1,048	$336,453	$4,929	(7.6%)
GERMANY	12,629	981	16,221	(121)	28.4%
SWITZERLAND	7,245	(539)	8,889	839	22.7%
UNITED KINGDOM	264,905	1,473	242,569	579	(8.4%)
ASIA	547,733	(2,385)	495,521	(2,985)	(9.5%)
JAPAN	473,761	(3,941)	435,484	(4,370)	(8.1%)
"OTHER ASIA"	20,654	2,938	18,500	(74)	(10.4%)
NONMONETARY INT'L & REGIONAL ORG'S	45,787	(809)	51,192	(276)	11.8%
TOTAL ALL COUNTRIES*	$1,023,470	($6,520)	$940,387	$3,969	(8.1%)

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

Taking advantage of the U.S. bond rally in the latter part of 2Q90, foreign investors returned to the U.S. Treasury market, with net purchases of close to $4 billion. In sharp contrast to the European investor's attitude toward U.S. equities, their net purchases of U.S. Treasuries, $4.9 billion, more than accounted for all net purchases. In contrast, Japanese investors made net sales of $4.4 billion in 2Q90. Gross transactions fell to $940 billion, down 8% from the previous quarter's $1 trillion.

The foreign investors' hesitance to purchase U.S. public debt has a real impact on financing the U.S. deficit. During the period 1980-89, foreign investors made net purchases of U.S. public debt issued equal to 14%. In the 1988-89 period, this percentage was nearly 24%. In stark contrast, foreign investors took down only 0.3% of U.S. government issuance in 1H90. While we don't profess to know what this means in actual basis points, we believe that interest rates are certainly higher now than they would be if foreign investment were anywhere near earlier levels.

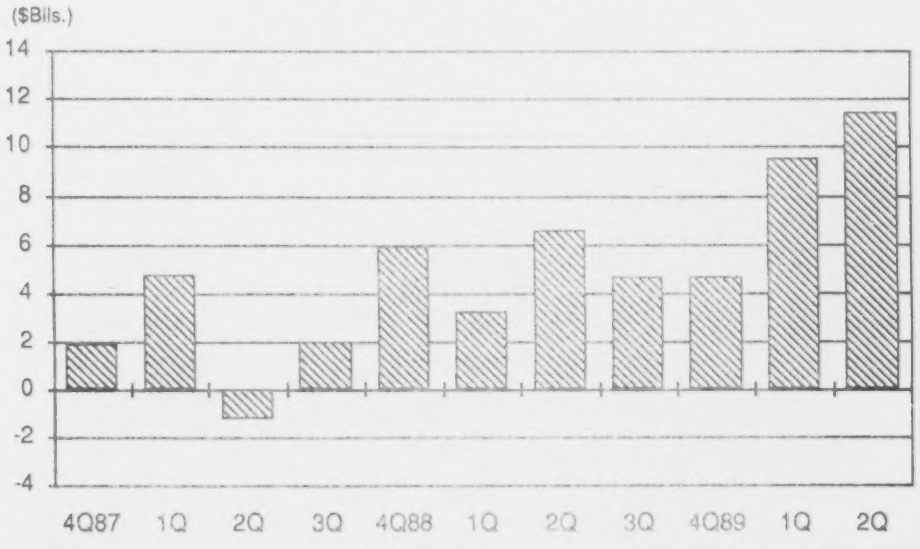
Foreign Interest In U.S. Public Debt Is On The Wane



U.S. Investment In Foreign Securities: A New Fixed Interest

U.S. investors outdid themselves in 2Q90, making record quarterly purchases of foreign securities totalling $11.5 billion. U.S. acquisitions were split almost equally between equities, $5.9 billion, and foreign bonds, $5.6 billion. Both were new records. First half 1990 totals are even more impressive, with U.S. capital outflows to overseas markets reaching $20.9 billion.

U.S. Net Purchases Of Foreign Securities



U.S. investors focused on EC countries and Japan. Except for net sales of $45 million in Belgium/Luxembourg and profit taking in West Germany, U.S. investors made net acquisitions in all other EC countries. The U.S. investment posture in West Germany, as well as that of other foreign investors, also reflected a growing realization of the economic problems that a unified Germany faces and less the euphoria cf quick economic gains. Data from the Deutsche Bundesbank underscores this point. To date, net equity inflows into West Germany total DM2.3 billion, a tenth of last year's inflows of DM23.3 billion.

GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($Mils.)

	FIRST QUARTER 1990		*SECOND QUARTER 1990*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 2Q90-1Q90*
EUROPE	**$42,923**	**$505**	**$37,873**	**$3,315**	**(11.8%)**
EUROPEAN COMMUNITY	*$38,549*	*$1,464*	*$35,436*	*$2,820*	*(8.1%)*
BELGIUM/LUXEMBOURG	595	67	741	(45)	24.5%
DENMARK	251	57	157	31	(37.5%)
FRANCE	3,464	(706)	2,628	354	(24.1%)
GERMANY	3,775	903	4,652	(374)	23.2%
GREECE	10	4	8	2	(20.0%)
IRELAND	133	75	34	10	(74.4%)
ITALY	3,507	931	1,245	577	(64.5%)
NETHERLANDS	1,982	100	2,103	87	6.1%
PORTUGAL	14	10	14	8	0.0%
SPAIN	906	116	1,702	272	87.9%
UNITED KINGDOM	23,921	(89)	22,152	1,898	(7.4%)
SWITZERLAND	3,329	(963)	2,036	356	(38.8%)
CANADA	**2,879**	**461**	**2,399**	**(3)**	**(16.7%)**
ASIA	**20,647**	**(1,235)**	**19,129**	**2,087**	**(7.4%)**
JAPAN	17,705	(1,349)	16,225	1,763	(8.4%)
OTHER	**6,350**	**624**	**4,341**	**489**	**(31.6%)**
TOTAL ALL COUNTRIES*	**$70,756**	**$299**	**$64,192**	**$5,888**	**(9.3%)**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

U.S. investors also purchased a record $1.8 billion in Japanese stocks in 2Q90. U.S. investors took advantage of the 25% drop (over 31% in U.S. dollar terms) in Japanese equity prices during 1Q90 by investing significant sums in the second quarter. While U.S. investors did miss out on the market's rise in the mid-1980s, the new investment pattern shows a willingness by U.S. investors to wade into the Japanese market given a "correction" in the valuation of Japanese equities.

We have recently chronicled significant U.S. investment in non-traditional markets such as Spain and Australia. Mexico has also received relatively large amounts of U.S. capital. The efforts by the Salinas government to renew the troubled Mexican economy

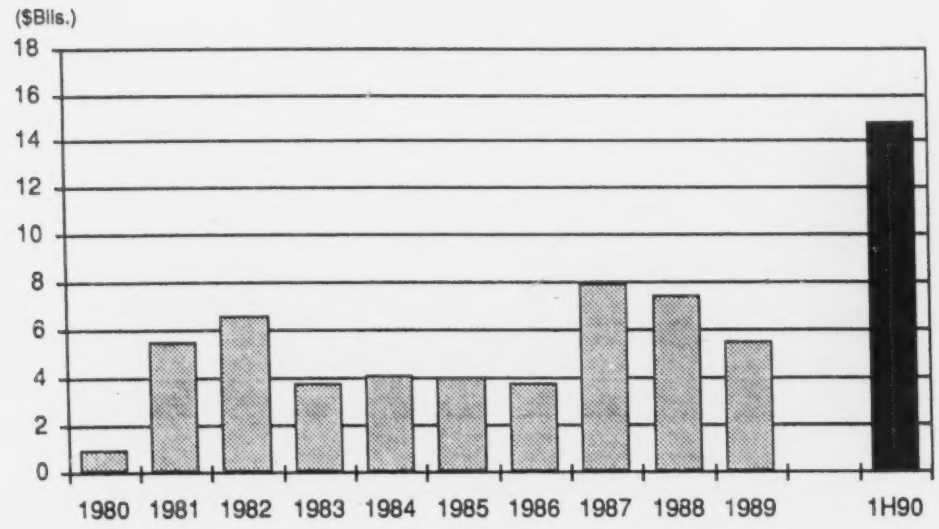
seems to be getting the okay from U.S. investors. Net investment in Mexican equities reached a record $300 million in 2Q90; this follows net acquisitions of $80 million in 1Q90. The U.S. posture toward Mexico, with the risks inherent in such investment, demonstrates the U.S. investors' increased interest in portfolio diversification as well as higher returns.

Main Beneficiaries Of
U.S. Net Equity Investment, 1H90
($Bils.)

U.K.	$1,974
Italy	1,508
Japan	414
Spain	388
Mexico	380

Of the five top countries receiving U.S. equity investment in the 1H90, only the U.K. and Japan would be considered mainstays of U.S. foreign equity investment. To put this in another perspective, in 1H90 over one-third of U.S. net foreign equity investment went to markets which account for only about 3% of the world's 1H90 equity capitalization.

U.S. Net Purchases Of Foreign Bonds

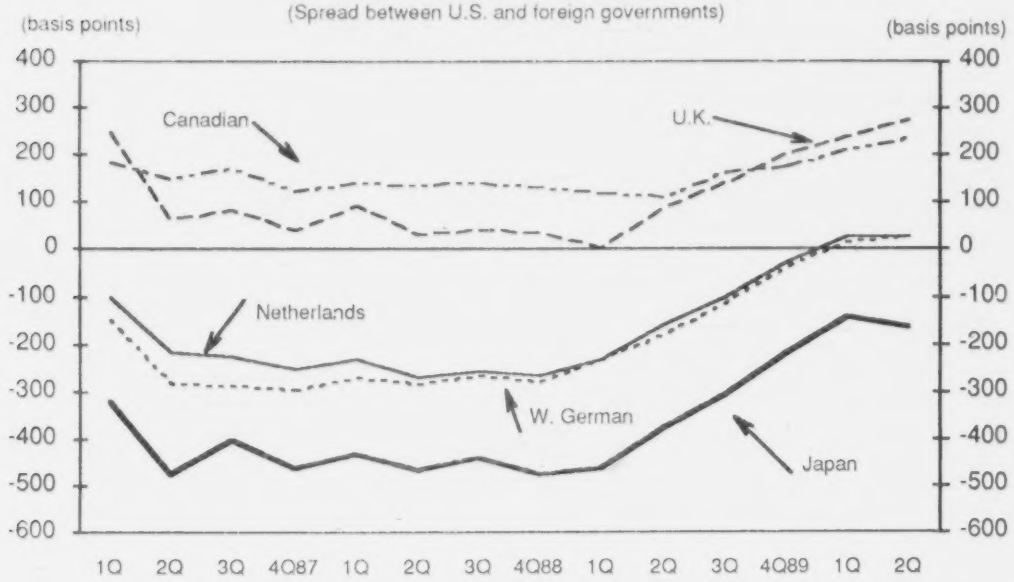


In 2Q90, U.S. net investment in foreign bonds totalled $5.6 billion. The 1H90 total of $14.7 billion was higher than any previous full year total. Higher yields overseas and

the prospect of a continued dollar weakening relative to foreign currencies bode well for overseas fixed-income investment. Indeed, by the end of 2Q90, U.S. governments had posted a small 2.1% return. In foreign markets, U.S. investors would have done far better. For example, a 8.95% return in long-term U.K. gilts or an 8.1% return in French governments. At shorter maturities, U.S. investors would have done even better.

U.S. Investors: In Search Of Higher Yields

(Spread between U.S. and foreign governments)



As noted earlier, the combination of foreign and U.S. outflows weakened U.S. securities markets in 1H90. Equally distressing, is the sharp curtailment in foreign direct investment. While still positive, direct purchases of U.S. assets in 1H90 were $10.5 billion according to the Department of Commerce's Office of Trade and Investment Analysis. This is just about a fourth of 1H89's record $38.4 billion, and the smallest amount since 1H86. The table below looks at both portfolio and direct investment and highlights the drastic falloff in total foreign investment.

Foreign Net Purchases of U.S. Financial Assets

($Bils.)

	1H90	*1H89*	*% Decrease*
Equities	$ (6.8)	$ 5.0	(236.0)%
Debt	10.1	37.3	(72.9)
Direct Investment	10.5	38.4	(72.7)
Total	$13.8	$80.7	(82.9)%

The curtailment in foreign direct investment contributes to lower securities prices in two ways. First, through decreased demand for these securities; and secondly, through the loss of the ripple effect, whereby large direct acquisitions often create increased value for other companies in the same industry which may become potential targets of foreign interests.

David G. Strongin
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GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS BY FOREIGN INVESTORS
($Mils.)

	FIRST QUARTER 1990		*SECOND QUARTER 1990*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 2Q90-1Q90*
EUROPE	**$14,478**	**$2,454**	**$16,237**	**$3,679**	**12.1%**
BELGIUM-LUXEMBOURG	695	(273)	826	(458)	18.8%
FRANCE	537	91	817	(337)	52.1%
GERMANY	970	(382)	727	(5)	(25.1%)
SWITZERLAND	719	282	1,033	487	43.7%
UNITED KINGDOM	10,251	2,661	11,592	3,114	13.1%
ASIA	**4,998**	**172**	**4,960**	**510**	**(0.8%)**
JAPAN	3,720	(84)	3,723	141	0.1%
"OTHER ASIA"	623	215	546	184	(12.4%)
TOTAL ALL COUNTRIES*	**$23,816**	**$3,165**	**$25,723**	**$5,785**	**8.0%**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions